

INTERNAL REVENUE SERVICE

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TE/GE TECHNICAL ADVICE MEMORANDUM

Internal Revenue Service
Attn: EO Mandatory Review
MC 4920 DAL
1100 Commerce Street
Dallas, TX 75242

UIL Code: 501.07-30

Taxpayer's Name:

Taxpayer's Address:

Taxpayer's Identification Number:

Years Involved:

Legend:

<u>Parent</u>	=
<u>Date</u>	=
<u>Schools</u>	=
<u>\$x1</u>	=
<u>\$x2</u>	=
<u>\$x3</u>	=
<u>\$x4</u>	=

This memorandum responds to a request dated June 3, 2010, from TEGE Exempt Organizations Examinations for technical advice. We have been asked to determine whether Parent was a "qualified organization" within the meaning of I.R.C. § 514(c)(9)(C) during its 2005 and 2006 tax years. Our findings are set forth below.

ISSUE:

Whether Parent was a qualified organization within the meaning of § 514(c)(9)(C) for purposes of determining whether income Parent derived from investment partnerships can be excluded from unrelated business taxable income.

FACTS:

The Parent was originally incorporated on Date. The Parent filed an Application for Exemption ("Application") stating that among other activities that the main purpose of the organization was to be the parent company of the healthcare system. The Application stated that the "Parent will conduct the usual activities associated with parent corporations in the tax-exempt healthcare field, including coordination of system-wide activities, overall strategic planning, overall policy development, system-wide medical education and medical research planning, capital and operating budgeting, capital and resource allocation, system-wide fundraising, system-wide human resource planning, legal compliance, system-wide accounting and reporting, oversight of taxable entities within the system and so forth." One of the main roles of the Parent is to hold and /or manage portions of the significant investment portfolio of the health care system.

According to its articles of incorporation, Parent is organized and operated:

... To conduct, execute, and perform a public trust to support, aid, and advance the study and investigation of human ailments and injuries and the causes, prevention, relief, and cure thereof, and the study and investigation of problems of hygiene, health, and public welfare, and the promotion of medical, surgical, and scientific learning, skill, education, and investigation, to conduct the practice of medicine and surgery and allied sciences, to provide medical, surgical, nursing, and hospital services, and to establish, operate, and coordinate clinics, medical and surgical centers, hospitals, and similar facilities, to assist and conduct or coordinate the conduct of, programs of medical education and medical research and to offer programs of graduate and undergraduate education and instruction in all fields of medicine, surgery, and related scientific study or coordinate the same, and, in the broadest sense, to engage in and conduct and to aid and assist in medical, surgical, and scientific education and research, and to make such educational, charitable, and public gifts and carry on such programs of public charity as may be incidental or related to the carrying out of the other stated purposes of the corporation....

The organization was granted tax-exempt status under § 501(c)(3) and was classified as a publicly supported organization under §§ 509(a)(1) and 170(b)(1)(A)(vi).

The Parent is set up as the parent entity of several separate subsidiaries, each of which has their own EIN and tax-exempt status. These separate subsidiaries control the various hospitals and clinics in the system, including a holding company that controls certain for-profit entities owned by the Parent.

In addition to acting as the parent of the healthcare system, the Parent also operates the Schools. The Schools were not part of the Parent when it was originally recognized

as described in § 501(c)(3) but were moved from another subsidiary to become an operating division of the Parent at a later date. The Schools are not separately incorporated. The Parent remained a publicly supported organization described in §§ 509(a)(1) and 170(b)(1)(A)(vi) after the addition of the Schools as an operating division of the Parent. The Schools represent 13% of the Parent's total functional expenses, with the remaining 87% of expenses attributable to fundraising and development, system-wide management, a medical journal, and "management and general." Fewer than 20% of the Parent's employees, half of which are residents and other students, are attributed to the educational program in the Parent's benefits and payroll system. Educational revenues in 2006 constituted 6% of the Parent's total program service revenue. Contributions categorized as educational normally represent about 7% of all contributions received; of the remaining 93%, about 80% is categorized as "research," "clinical," "charity/other," or "capital" and 13% is categorized as "unrestricted."

The Parent takes the position that it is a "qualified organization" within the meaning of § 514(c)(9)(B)(vi) because it is an "educational organization" described in § 170(b)(1)(A)(ii) and therefore does not have to treat indebtedness incurred in acquiring or improving real property as "acquisition indebtedness" for purposes of § 514. Based on this position, the Parent filed Form 990-Ts for the 2005 and 2006 tax years to report unrelated debt-financed income in the amounts of \$x1 and \$x2 for investments that the Parent made in several partnerships holding debt-financed real property. However, if Parent is not a qualified organization within the meaning of § 514(c)(9)(A), the Parent should have reported unrelated debt-financed income in the amounts of \$x3 and \$x4, respectively.

LAW:

I.R.C. § 170(b)(1)(A)(ii) describes an educational organization as an organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are carried on.

I.R.C. § 511 imposes a tax on the unrelated business taxable income of organizations otherwise exempt from federal income tax under section 501(c).

I.R.C. § 512(a) defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (as defined in § 513) regularly carried on by it, less the deductions allowed by Chapter 1 of the Code that are directly connected with the carrying on of such trade or business, both computed with the modifications provided in § 512(b).

In computing unrelated business taxable income, § 514(a)(1) includes as an item of

gross income derived from an unrelated trade or business an amount that is the same percentage (but not in excess of 100 percent) of the total gross income derived during the taxable year from or on account of debt-financed property as (A) the average acquisition indebtedness for the taxable year with respect to the property is of (B) the average amount of the adjusted basis of such property during the period it is held by the organization during the taxable year.

I.R.C. § 514(c)(9) provides that certain categories of exempt organizations are excused from the debt-financed property rules with respect to the acquisition and improvement of real property. Specifically, the term "acquisition indebtedness" does not include indebtedness incurred by a "qualified organization" in acquiring or improving real property. Among the types of exempt organizations that are defined as "qualified organizations" are educational organizations described in § 170(b)(1)(A)(ii). When debt-financed real property is held by a partnership, the exception under § 514(c)(9) does not apply unless the partnership meets the requirements of § 514(c)(9)(B)(i)-(vi).

Treas. Reg. § 1.170A-9(c)(1) provides that an educational organization is described in § 170(b)(1)(A)(ii) if its primary function is the presentation of formal instruction and it normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The term does not include organizations engaged in both educational and non-educational activities unless the latter are merely incidental to the educational activities. For example, the operation of a school by a museum does not necessarily qualify the museum as an educational organization.

Rev. Rul. 76-416, 1976-2 C.B. 57, states that a hospital described in § 170(b)(1)(A)(iii) that has established that it meets the public support requirements of § 170(b)(1)(A)(vi) (describing organizations that receive a substantial part of their support from governmental units or the general public) may qualify as an organization described in § 170(b)(1)(A)(vi). See also Rev. Rul. 78-95, 1978-1 C.B. 71 (a church described in § 170(b)(1)(A)(i) is not prevented by the regulations from also being described in § 170(b)(1)(A)(vi) if it meets the requirements for being publicly supported).

Rev. Rul. 56-262, 1956-1 C.B. 131, concerns an organization that was incorporated for the primary purpose of engaging in research into the cause, origin, prevention, and cure of certain diseases. The organization also provides advanced instruction and training of personnel seeking to become qualified to engage in effective research operations in this field. Two groups of students are maintained: research specialists of professional rank and graduate students seeking the degree of Doctor of Philosophy in science. Research specialists attend lectures and seminars which provide the opportunity for acquiring knowledge and techniques relating to the research and the experimental treatment of certain diseases. The graduate student program is carried out under an

agreement with a medical college whereby the facilities of the research organization are made available to certain graduate medical students of the college. Formal instruction taken by such students, who may or may not be employees of the research organization, is deemed to be work done "in residence" at the medical college. The ruling states that an organization which has educational activities in the broad sense of the word and which, incidental to its primary functions, regularly maintains a faculty and a curriculum and regularly has students in attendance at the place where its educational activities are conducted, is not an "educational organization" referred to in § 170(b)(1)(A)(ii) of the Code. Only those "educational organizations" organized primarily for, and engaged in, the presentation of formal education in the instructive sense constitute "educational organizations" within the meaning of § 170(b)(1)(A)(ii) of the Code.

Rev. Rul. 58-433, 1958-2 C.B. 102, concerns an organization that collects coins and medals, maintains a museum and library that conduct summer seminar and scholastic research projects, and provides instruction and supervision of post-graduate students. The organization has an average of 35 persons on the post-graduate level during a regular academic year studying numismatics and the history of numismatics, with each student under the supervision and guidance of one of the organization's staff of experts. In addition, the facilities of the organization are employed by scholars the world over, either by attendance or by use of the organization's publications to further their research. The ruling holds that where the principal purpose and functions of the organization are the collection and preservation of coins and medals and the maintenance of a museum, library, and other facilities for research, with secondary activities consisting of the employment of its museum, library, and other facilities in furtherance of the organization's educational aims in the graduate and post-graduate study of numismatics and related fields, the organization does not constitute an educational organization of the type referred to in § 170(b)(1)(A)(ii).

ANALYSIS:

Based on the facts and representations we rule as follows:

Parent was organized and operated during its 2005 and 2006 tax years as the parent of an integrated health group practice. As part of its activities, Parent coordinates the operation of Schools. The Parent also performs administrative duties for both the Schools and the entire healthcare system, which includes hospitals, research centers, clinics, and several taxable entities.

Parent maintains that it is an educational organization described in § 170(b)(1)(A)(ii). Although, for foundation classification purposes, the IRS recognizes Parent as an organization described in § 170(b)(1)(A)(vi), Parent may also be "described in" §

170(b)(1)(A)(ii) if it meets the requirements of that section. See Rev. Rul. 76-416; Rev. Rul. 78-95. The Schools, which are an operating division of the Parent and not separately incorporated, normally maintain a regular faculty and curriculum and normally have an enrolled body of students in attendance at the place where the educational activities are carried on. Thus, whether the Parent is an organization described in § 170(b)(1)(A)(ii) hinges on whether it has, as its primary function, the presentation of formal instruction.

While the Schools operated by the Parent may engage in the presentation of formal instruction, we do not find, under the facts and circumstances presented, that the Parent's *primary* function is the presentation of formal instruction for the students of the Schools. Nor do we find that the clinical and research practices are merely incidental to the healthcare system's formal educational program. Rather, we note that Parent's formal instruction through the Schools represents only 13% of the Parent's total functional expenses, with the remaining 87% of expenses being attributable to the Parent's fundraising, system-wide management activity, development program, medical journal, and "management and general." About 20% of the Parent's employees, half of which are residents and other students, are attributed to the educational program in the Parent's benefits and payroll system. Educational revenues in 2006 constituted a mere 6% of the Parent's total program service revenue, while contributions categorized as educational normally represent only about 7% of all contributions the Parent receives. Thus, the Parent's formal instruction through the Schools is not the Parent's primary function. Rather, the Parent's primary function consists of acting as the parent company of a healthcare system by coordinating and planning system-wide activities and conducting system-wide fundraising and development.

In this respect, Parent is similar to the organization described in Rev. Rul. 56-262 that, although it maintained a regular faculty, curriculum, and student body, did not qualify as an educational organization described in § 170(b)(1)(A)(ii) because formal instruction was only incidental to its primary function of conducting research into the cause, prevention, and cure of diseases. Like that organization, Parent's primary function is not the presentation of formal education in the instructive sense, but is, instead, serving as the parent of an integrated enterprise that is educational in the broad sense of "advanc[ing] the study and investigation of human ailments and injuries and the cause, prevention, and cure thereof" (see Articles of Incorporation). The formal educational activities of the Schools are incidental to that primary function.

Parent is similar, as well, to the organization described in Rev. Rul. 58-433 which also did not qualify as an educational organization described in § 170(b)(1)(A)(ii) because, though it used its museum and library to provide formal training for a small body of post-graduate students, its primary purpose and function was to collect and preserve coins and medals for general research. Like that organization, Parent, although it uses its

facilities for the formal training of students in its Schools, has as its primary purpose and function the coordination of, and fundraising for, the clinical, research, and educational components of the organization. Consequently, because we find that Parent's primary function is not the presentation of formal instruction, we conclude that it does not qualify as an educational organization within the meaning of § 170(b)(1)(A)(ii).

CONCLUSION:

Parent is not an educational organization as defined in § 170(b)(1)(A)(ii), therefore it is not a qualified organization within the meaning of § 514(c)(9)(C).

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. This ruling does not address the applicability of any section of the Code or regulations to the facts submitted other than with respect to the sections described. Because it could help resolved questions concerning your federal income tax status, this ruling should be kept in your permanent records.

A copy of this memorandum is to be given to Parent. Section 6110(k)(3) provides that it may not be used or cited as precedent.

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